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OUTLOOK

FOR THE ECONOMY AND REAL ESTATE

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Outlook for the Economy and Real Estate

The revised annual growth rate for third quarter real Gross National Product of 4.3 percent reflects a transitory boost from end of the fiscal year federal spending and discount auto financing. This real growth rate is unlikely to continue in the present quarter given the huge level of consumer debt and the record low personal savings rate. In October, retail sales dropped off 3.3 percent and aggregate personal outlays declined 0.9 percent mostly due to reduced auto sales, but also because consumers are reining in their spending to reduce debt burdens and replenish savings. With growth of consumption spending slowing, renewed economic growth depends heavily on business investment. Inventory investment will rise as a consequence of the recent flurry in durable goods spending, but these advances should be offset by the expected slow pace of residential and non residential fixed investment. Accordingly, GNP growth should remain at about 2.0 percent in the fourth quarter of 1985 and at or below that level through 1986.

The unemployment rate for October remained at 7.1 percent despite the creation of 323,000 new jobs. This indicates the economy is not expanding fast enough to absorb new entrants to the job market. With lackluster GNP growth expected, the unemployment rate could slowly rise through 1986, ending 1986 at about 7.5 percent. A rebounding economy in 1987 could generate enough jobs to reduce the unemployment rate modestly.

Consumer price inflation should remain moderate through 1985 and 1986 because weakening capacity and additional people looking for work prevent either demand pull or supply push inflation. Consumer prices in 1986 should track below 1985 at 3.2 percent in part because of slower overall economic growth. Stronger GNP growth in 1987 should be accompanied by a slightly higher inflation rate of about 3.6 percent. For all of 1985, producer prices are expected to decrease 0.6 percent before accelerating modestly in 1986 and 1987.

Slower GNP growth in 1986 will reduce the overall investment demand and allow long term interest rates to trend downward during 1986. Continuation of low levels of inflation will reduce inflationary expectations in the future. The recent Congressional delay in raising the national debt ceiling prevented the Treasury from raising the necessary operational funds for the government in the credit markets. As a result, unusually large government auctions should cause short term interest rates to rise in the present quarter and into the first quarter of 1986, but should then trend downward through 1986.

Real Estate Markets

With mortgage interest rates declining and affordability improving, the outlook for the real estate sector is positive. Sales of existing single family homes rose to an annual rate of 3.49 million units in October, a 27.4 percent increase over October 1984. This marked the eighth month in 1985 that resale activity exceeded 3.0 million units, a performance not equalled since the 1976-1980 period. With the continuing drop in mortgage interest rates, sales of existing single family homes should rise to over 3.3 million units in 1986 and about 3.4 million units in 1987. Due to the strong demand for new and existing homes, builders are gaining confidence in constructing more homes. This was the likely impetus for strong growth in October housing starts activity that registered a 10.8 percent gain over September to achieve an annual rate of 1.76 million units. Housing starts should continue at about 1.76 million units through 1985 before strengthening to 1.84 million units in 1986 and 1.87 million units in 1987. Unfortunately, first time homeowners comprise a smaller proportion of sales than in the 1970's reflecting the greater difficulty of saving the downpayment and affording the monthly payments. This is a primary cause of the five year downturn in the homeownership rate, from 66% in 1980 to 64% in 1985.

Commercial Real Estate

While a favorable downward trend in long term interest rates is welcome news to the nonresidential building sector, the prospects of a continued sluggish economy, federal budget cutbacks, and the uncertainty of tax reform make for a mixed outlook in this sector. Total nonresidential construction should peak at just under 1.3 billion square feet for 1985, and fall to about 1.2 billion square feet in 1986. Construction of office buildings, though currently on a near record-breaking pace of 310 million square feet, will drop off considerably to 250 million square feet in 1986 as builders adjust to the anticipated effects of a tax reform package and a vacancy rate that has tripled since 1981.

Stores and other commercial construction, which traditionally responds to housing construction, can be expected to end 1985 at the rate of 548 million square feet. Retail building, accounting for 425-475 million square feet of this total, should maintain this rate through 1986 as long as lower mortgage interest rates continue to spur housing demand. Allowing for slow economic growth and the possibility of tax reform, building in this sector should drop to 507 million square feet in 1986 with retail construction accounting for 450 million square feet.

Industrial building construction has suffered from the major problems facing the manufacturing sector. The over-valued U.S. dollar, brought on by federal deficit spending, has led to high real interest rates and resulted in record-breaking trade deficits that have dragged manufacturing operating rates slowly downward. Even a measured, steady fall in the value of the U.S. dollar will take a few years to translate into major improvement in the U.S. trade balance. Industrial construction should continue at about 140 to 145 million square feet through 1986.

Commercial and Industrial Building Contracts

	Stores and Other Commercial		Office Buildings		Industrial Buildings	
Year	millions of sq ft	percent change	millions of sq ft	percent change	millions of sq ft	percent change
1981	337	-11%	325	+15%	187	-13%
1982	245	-27%	261	-20%	118	-37%
1983	362	+48%	281	+ 8%	107	-37%
1984	478	+32%	318	+13%	144	+33%
1985p	548	15%	310	- 3%	140	- 3%
1986f	507	-7%	250	-19%	145	+ 4%

p: preliminary
f: forecast

Source: Historical Data: DRI, Review of the U.S. Economy, November 1985.
Forecasts: NATIONAL ASSOCIATION OF REALTORS®